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UNCLAS SECTION 01 OF 02 ISTANBUL 000113

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TREASURY FOR OASIA - MILLS AND LEICHTER
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TAGS: ECON EFIN PREL TU
SUBJECT: ISTANBUL MARKETS "WAIT AND SEE" ON GOVERNMENT POLICY AND IRAQ: BETTING ON U.S. AID

REF: ANKARA 628

Sensitive but Unclassified - not for internet distribution.

¶1. (SBU) Summary: Leading Istanbul bankers and market analysts see current market sentiment as one of "watchful waiting," but believe that despite recent declines in the stock market, there is an underlying expectation that the Turkish government will reach agreement with the IMF on the fourth review and with the U.S. on Iraq modalities. Analysts concede that AK's "learning curve has been expensive," and that the new government's economic policies remain Turkey's biggest risk (especially on bank sector reform), but they are betting at the end of the day on international recognition of Turkey's interests. End Summary.

¶2. (SBU) Complacency and Watchful Waiting: In a round of separate meetings on January 22 and 23 with visiting Ankara DCM and Deputy Econ Counselor, financial and market analysts predicted that AK would "stick with the program" and not permit relations with either the IMF or United States to reach an impasse. Citibank Country Risk Manager Peter Rossiter characterized the markets as complacent, and himself offered a relatively sanguine view of the government, arguing that it is not "intentionally" departing from the ongoing reform program, but instead has been hampered by its inexperience and lack of depth in its economic team. He conceded that the government's lack of fiscal discipline is a serious concern, and that Citibank remains concerned about how Turkey will "bridge the gaps" that may occur as a result of an Iraq operation and its own fiscal policies, but noted that the bank's customers do not appear to share these worries. "The moral hazard of potential U.S. assistance is serious," he noted. More generally, however, he saw fundamentals in Turkey moving in a positive direction, saying that Citibank's overall perspective is more positive than a year ago as a result of enhanced political stability, a stabilized banking system and companies that are "earning their way out of the 2001 crisis."

¶3. (SBU) Getting in on the Game: Pointing to the Treasury's successful January 22 auction, observers also drew attention to the reappearance of foreign investors in the market. While conceding that the core of the market remains the key banks that cannot afford to exit (given that T-bills make up 35-40 percent of their assets), Bender analysts Murat Gulkan and Emin Ozturk attributed foreign demand to the success of last year's carry trade, where investors realized a 65-70 percent return based on a relatively stable exchange rate. Morgan Stanley, they noted, had recently put out a paper on this issue.

¶4. (SBU) Difficult Relations: While conceding that the agenda for completion of the much-delayed fourth review remains daunting, analysts were virtually unanimous that the market anticipates resolution of the outstanding issues. Even Global's Cem Akyurek, traditionally a sceptic about the government, expects its completion, while analysts at TEB investment argue that the government has "no choice" but to reach a settlement. Disbank's Tayfun Bayazit expects a satisfactory budget and abandonment of the most controversial proposed procurement law amendments, but sees the oustanding Pamukbank/Yapi Kredi problem as the key imponderable (reftel). Beyond the January 31 deadline facing the banking board on that issue, all pointed to other key milestones including submission of the budget in late January. Observers agreed that the market expects the IMF to return by mid-February, and while some slippage may be allowed because of the upcoming holiday (the entire week of February 10), any delay beyond that point will damage market confidence.

¶5. (SBU) Moral Hazard: Other banking and market analysts shared Citibank's belief that the expectation of U.S. assistance has created a moral hazard to one degree or another, and is encouraging the markets to look beyond such key issues as the sustainability of real interest rates. There was a general consensus from our interlocutors that the markets believe that the U.S. and IMF will take a more charitable view of Turkey's actions in the event of an Iraq operation. We reiterated to all interlocutors that any U.S. assistance is conditioned not just on military cooperation but on continued economic reform.

¶6. (SBU) Comment: If markets are sanguine about the immediate future, there remains an underlying pessimism about Turkey's long-term prospects. Akyurek, who has headed Global's research department for five years, argued that essentially "AK doesn't understand the Washington consensus" and remains Turkey's biggest risk. The fact is especially frustrating, he argued, because Turkey "doesn't need a lot for takeoff-- 1-2 billion in FDI and 3-4 billion in loans would suffice." But for that to occur, Turkey needs 3 good years of "flawless economic management." In his view, and in that of most of those we talked to, while Turkey may get through the next few months, it is very unlikely to get to that take-off point. End Comment.
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